

# Timber Sales Qualifying for Capital Gains Treatment

## Tennessee Department of Agriculture, Division of Forestry

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To qualify for long-term capital gains treatment, timber owners must own their timber primarily for profit, hold it for more than a year and, if they are considered “in the timber business”, sell according to IRS Section 631(a) and (b). (*See Forestry Information Sheet on filing status*).

Section 631(a) allows the timber owner to elect capital gains treatment of income from timber he cuts himself. The IRS terms Section 631(a) “electing to treat the cutting as a sale”. Section 631(a) income is divided between capital gains and ordinary income. The capital gain is determined by subtracting the basis and sale expenses from the fair market value as of the beginning of the tax year. The ordinary income is the price received for the harvested timber minus the fair market value of the stumpage.

Section 631(b) provides capital gains treatment for sale of stumpage with an “economic interest retained”. This precludes selling by lump sum. In a lump sum sale, the buyer owns the uncut timber, so the seller no longer retains an “economic interest” in it. Timber sold under 631(b) must be cut “on shares” or on a per-unit basis for the seller to retain an economic interest.

Those who qualify as “investors” can sell timber by any method, including lump sum, and get capital gains treatment on the sale.

Often, selling by sealed bid using the lump sum method will bring the highest price. An attorney can write a carefully worded 631(b) contract that is essentially a lump sum sale presented as a shares sale with an economic

interest retained. The contract should contain the terms “lessor” and “lessee” to avoid any appearance of a lump sum sale.

Investors report timber income on Form T, Schedules C and F, and on Form 1040 Schedule D.

631(b) sales are similarly reported on Form T, Schedules C and F, Form 1040 Schedule D, and on Form 4797, Sale of Business Property. The buyer is required to supply the seller with a Form 1099.

631(a) sales are reported in two segments, one for capital gains and one for ordinary income. Capital gain is reported on Form 4797 Part I and on Form 1040 Schedule D; ordinary income is reported on Form 4797 part II and on Form 1040, Schedule C (business schedule). Again, Form T, Schedules C and F are filed. List expenses, including fair market value, as “other expenses” on 1040 Schedule C. Give the details of the sale on Form T Schedules C & F or on a plain piece of paper; include how depletion basis and fair market value were determined. Elect to file as a 631(a) sale on Form T, Schedule F. Once made, this decision cannot be changed without permission of the Commissioner of the Internal Revenue Service.

*This document is educational in nature and is not intended to serve as tax advice or to take the place of a professional tax accountant.*

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